

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Commonwealth Edison Company	:	
	:	Docket No. 11-0721
Formula rate tariff and charges	:	On Rehearing
authorized by Section 16-108.5 of the	:	
Public Utilities Act.	:	

**BRIEF ON EXCEPTIONS ON REHEARING OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION**

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Staff of the Illinois Commerce Commission (“Staff”), by and through its counsel, pursuant to the direction of the Administrative Law Judges (“ALJs”) and Section 200.800 of the Illinois Administrative Code, respectfully submits its Brief on Exceptions to the Administrative Law Judges’ (“ALJs”) Proposed Order on Rehearing issued August 31, 2012 (“Proposed Order On Rehearing” or “PO On Rehearing” or “ALJ PO On Rehearing”).

I. INTRODUCTION

On November 8, 2011, Commonwealth Edison Company (“ComEd”) filed its performance-based formula rate tariff, Rate DSPP – Delivery Service Pricing and Performance (“Rate DSPP”) under Section 16-108.5 of the Public Utilities Act (“Act” or “PUA”). Section 16-108.5 of the PUA was enacted as part of the Energy Infrastructure and Modernization Act (“EIMA”) (Illinois Public Act 097-0616, as amended and supplemented by PA 097-0646). On May 29, 2012 the Illinois Commerce Commission

("Commission") issued its order in this matter ("May 29 Order"). On June 5, 2012, an Application for Rehearing was filed by ComEd. The Commission granted in part and denied in part ComEd's Application for Rehearing on June 21, 2012. Rehearing was granted on the following three issues: the pension asset issue, average year vs. year-end rate base; and the methodology regarding calculation of interest on reconciliation adjustments. The Proposed Order On Rehearing rejects not only Staff's but the Commission's own recommendations regarding the Pension Asset Issue and the Methodology regarding Calculation of Interest on Reconciliation Adjustments. Accordingly Staff takes exception to the ALJs conclusions set forth in the Proposed Order On Rehearing on those two issues. In addition, the PO on Rehearing does not accurately and adequately summarize Staff's position on the pension and interest rate issues. Staff's brief on exception on Rehearing ("BOE On Rehearing") follows.

II. ARGUMENT

1. Pension Issue

a. Pension Asset

i. Analysis and Conclusions

Commission Practice is Relevant and Important to the EIMA

The PO On Rehearing does not provide a sound basis for the Commission to reverse its conclusions on the pension asset issue. It begins its incorrect approach to this issue with the following unfounded statement:

We note at the outset that Section 16-108.5 of the Public Utilities Act is a new statute that sets forth a new methodology for determining rates for electric utilities. **Therefore, Commission precedent and other portions of the Act are not determinative here.**

(PO On Rehearing, p. 21)(emphasis added) Despite the PO On Rehearing's claim to the contrary, Commission orders regarding the EIMA must be consistent with Commission practice and the Act. The PO On Rehearing makes this erroneous claim despite the fact that the PO On Rehearing acknowledges that "[w]ell established rules of statutory construction require interpretation of the General Assembly's intent in a manner that avoids an absurd, unjust or unreasonable result" (PO On Rehearing, p. 16) and "[t]he best indication of the legislative intent is the statutory language," (Id., p. 21)

In dismissing the relevance of Commission past practice, the PO On Rehearing is directly at odds with the plain language of EIMA which unambiguously requires the formula rate approved by the Commission to "[p]rovide for the recovery of the utility's actual costs of delivery services that are prudently incurred and reasonable in amount **consistent with Commission practice** and law." (220 ILCS 5/16-108.5(c)(1)) (emphasis added) The PO On Rehearing dismisses this language and other similar language despite the fact that, statutes are to be construed so that no term is rendered superfluous or meaningless. *Stroger v. Regional Transportation Authority*, 201 Ill.2d 508, 523 (2002). Moreover, the portion of the statute that refers to the protocol of setting a long-term debt return on pension assets net of deferred tax benefits must be read together with the statutory language that requires such protocols to be "consistent with Commission practice and law." (220 ILCS 5/16-108.5(c)(4) and 16-108.5(c)(4)(D). Statutes should be construed as a whole, with all relevant parts considered. *In re Marriage of Kates*, 198 Ill.2d 156, 163; 761 N.E.2d 153, 157 (2001).

In dismissing the relevance of “other portions of the Act”, the PO On Rehearing directly contradicts the EIMA which unambiguously requires the Commission to conduct its investigation of the Company’s formula rate filing “**in a manner consistent with the provisions of this subsection (c) and *the provisions of Article IX of this Act to the extent they do not conflict with this subsection (c).***” (220 ILCS 5/16-108.5(c)) (emphasis added).

In addition to Section 16-108.5(c) and Section 16-108.5(c)(1) specifically requiring that Commission orders regarding formula rates are to be consistent with Commission practice, subsections (2) and (4) of Section 16-108.5(c) impose the exact same requirement. Also, in Sections 16-108.5(c) and 16-108.5(c)(5) there is the requirement that Commission orders under Section 16-108.5 are to be in accordance with prior Commission orders. Subsection (c)((5) states that the formula rate shall:

[p]rovide that if the participating utility's earned rate of return on common equity related to the provision of delivery services for the prior rate year (calculated using costs and capital structure approved by the Commission as provided in subparagraph (2) of this subsection (c), consistent with this Section, in accordance with Commission rules and orders, including, but not limited to, adjustments for goodwill. (220 ILCS 5/16-108.5(c)(5)) (emphasis added)

and subsection (c) states that:

[u]ntil such time as the Commission approves a different rate design and cost allocation pursuant to subsection (e) of this Section, rate design and cost allocation across customer classes shall be consistent with the Commission's most recent order regarding the participating utility's request for a general increase in its delivery services rates.” (220 ILCS 5/16-108.5(c)) (emphasis added)

Since as the PO On Rehearing acknowledges “[t]he best indication of the legislative intent is the statutory language...” (Id., p. 21), the legislature, by making numerous

references to Commission practice and Commission orders clearly intended for prior Commission orders to be determinative under Section 16-108.5.

It is self-contradictory that the PO On Rehearing makes the statement that “Commission precedent and other portions of the Act are not determinative” since the ALJs in their PO issued on May 1, 2012 specifically cited to a section of the EIMA which supports the position that the Commission must consider its prior orders. In the May 1, 2012 PO, the ALJs set forth that the EIMA requires that:

...the performance-based formula rate approved by the Commission shall “provide for the recovery of the utility's actual costs of delivery services that are prudently incurred and reasonable in amount consistent with Commission practice and law.” (220 ILCS5/16-108.5(c)(1)). In previous orders, the Commission did in substance, but not in form, what ComEd asks the Commission to do here. While the Commission, in dockets 05-0597, 07-0566 and 10-0467, did not specifically state that it was allowing recovery of an amount that was placed in ComEd’s pension (that was above and beyond what ComEd normally pays into its pension plan), as a “pension asset,” it allowed recovery of and on such contribution. Because the statute requires recovery in a manner that is consistent with Commission practice, the Commission declines to adopt Staff’s adjustment on this issue.

(PO, p. 112)(emphasis added)

Indeed, prior Commission practice is determinative under Section 16-108.5. As Staff has discussed throughout this proceeding,

- Prior Commission practice has consistently defined “pension asset” as one that exists only when a pension trust fund is overfunded (Docket No. 05-0597, July 26, 2006, Final Order at 39; Docket No. 11-0721, May 29, 2012, Final Order at 111, 114; Staff IB On Rehearing, pp. 4-5; Staff RB On Rehearing, p. 10)

- The Commission has never found ComEd to have a pension asset (Docket Nos. 05-0597 and 10-0467, Staff IB On Rehearing, pp. 8-10; Staff RB On Rehearing, p. 19)
- The Commission has granted a debt-based return on **only** the discretionary pension contribution to ComEd as an operating expense, in recognition that such prepayments mitigated future pension expense and resulted in a ratepayer benefit (Docket Nos. 05-0597, 07-0566, and 10-0467; *Tr.*, March 9, 2012, pp. 457-460, Staff IB On Rehearing, pp. 8-10; Staff RB On Rehearing, p. 19) It should be undisputed that the Commission has never allowed a return on normal pension contributions.

“Pension Asset” Is A Term of Art Whose Meaning is Not Plain or Ordinary

The ALJs in rejecting Staff’s position on this issue rely upon the incorrect premise that “the term “pension asset” consists of two words that must be given their plain ordinary meaning, in compliance with well-established rules of statutory construction.” (PO On Rehearing, p. 21) The ALJ’s May 1, 2012 proposed order made this same argument (PO, p. 112) and the Commission soundly rejected it in its May 29 Order. (May 29 Order, pp. 113-114) The ALJs would have the Commission simply accept the amount that ComEd labels on its FERC Form 1 as a pension asset. (PO On Rehearing, p. 21) Since Section 16-108.5 does not define “pension asset”, the mere fact that ComEd chose to label an amount in its FERC Form 1 as a “pension asset” is not controlling on the Commission. The PO On Rehearing overlooks the fact that the Commission is required to analyze transactions and is not resigned to merely accept the

accounting practices of the utility appearing before it. (*Harrisonville Telephone Co. v. Illinois Comm. Comm'n*, 343 Ill. App.3d 517, 536 (2003)) (Staff IB On Rehearing, p. 24)

Despite the ALJs' statement, however, the term "pension asset" does not have a "plain ordinary meaning." As Staff pointed out in its BOE in the original proceeding, the fact that expert witnesses for Staff and the Company have opposing definitions for the term "pension asset," is evidence that it does not have a "plain ordinary meaning" (Staff BOE, p. 20) and therefore is ambiguous. If defining the term was as simple as the ALJs suggest (i.e., just look it up in a Merriam Webster dictionary) then neither ComEd nor Staff would have found it necessary to offer a witness defining the term. What was evident to the Commission in the original proceeding and has not changed since the Commission's May 29 Order is that the EIMA simply does not define the term "pension asset". (May 29 Order, p. 113) Staff's approach, which the Commission's May 29 Order adopted, looks at the overall status of the pension plan and all its components as it relates to the utility on a stand-alone basis, including:

- 1) the current fair value of the assets in ComEd's share of the pension trust
(rather than the amount of contributions made in the year);
- 2) ComEd's share of the pension benefit obligation (rather than the amount of
expense to be recognized in the year); and
- 3) the overall funded status of ComEd's share of the plan (rather than the
prepayment of pension costs for the year).

That approach is more encompassing than the PO's On Rehearing's narrowly focused definition that only considers "an item of value" even when such item has a negative

balance or off-setting liabilities (PO On Rehearing, p. 21), which was previously rejected by the Commission. (May 29 Order, pp. 113-114)

The PO On Rehearing compounds its error by attempting to deduce the plain meaning of the term “pension asset” by parsing it and looking up the definition of each word in a dictionary. (PO On Rehearing, p. 21) The flaw here is that the sum of the parts does not make up the whole. For example, the terms “balance sheet” and “rate base” are also terms used in the regulatory context.¹ Each of these terms cannot be similarly parsed as the PO does: determine the meaning of each word in the term by using in a dictionary and combine those definitions to arrive at the meaning of the term. The PO’s approach provides a result that vastly differs from the terms’ true meaning. The Commission rejected this incorrect approach originally proposed by the ALJs in the May 1, 2012 PO and should do so again. The May 29 Order appropriately defined pension asset consistent with the Commission’s past practice and there is no compelling reason why the Commission should depart from that practice. As discussed above, the legislature clearly intended for Commission Orders under Section 16-108.5 to be consistent with Commission practice.

The ALJs by parsing pension asset into two words fail to recognize that “pension asset” is a term of art in the regulatory context. Black’s Law Dictionary defines a term of art as “[a] word or phrase having a specific, precise meaning in a given specialty, apart from its general meaning in ordinary contexts.” (Black’s Law Dictionary, Eighth Edition)

¹ The term “balance sheet” appears several times in the PUA in sections 5/3-125, 5/5-103 and 9-220, yet is not defined in the PUA.

The term “rate base” appears numerous time in the PUA in sections 5/7-105, 5/7-106, 5/9-211, 5/9-212, 5/9-213, 5/9-214 and 5/9-217, yet is not defined in the PUA.

In the Illinois regulatory context the Commission has found that a pension asset exists when the value of the investment in the pension plan exceeds the liabilities which those investments are intended to cover. (Staff IB On Rehearing, p. 10) While Staff recognizes that the Commission has broad authority to define the term “pension asset”, Staff recommends that it should do so consistent with its prior orders. (Staff Reply Brief on Rehearing, pp. 5-9)

Based on the foregoing discussion, the Commission should reject the PO On Rehearing’s Analysis and Conclusion on the pension asset issue and revise the sixth Finding and Ordering paragraph as indicated below.

Proposed Modification
(PO On Rehearing, pp. 20-21)

[Delete the entire Analysis and Conclusions section and replace with the following.]

Analysis and Conclusions

Section 16-108.5 allows a utility to recover an: “investment return on pension assets net of deferred tax benefits equal to the utility’s long-term debt cost of capital as of the end of the applicable calendar year. . . .” (220 ILCS5/16-108.5(c)(4)(D)). Staff and ComEd continue to differ as to how they define the term “pension asset” in this statute. In this rehearing ComEd has failed to persuade the Commission that it should change the Commission’s May 29 order’s conclusion on this issue. The Commission’s May 29 Order concluded that the ratemaking determination for the inclusion of a pension asset should be based on a much broader approach than ComEd’s narrow view. Staff’s approach views the overall status of the pension plan and all its components as it relates to the utility on a stand-alone basis, including: 1) the current fair value of the assets in ComEd’s share of the pension trust (rather than the amount of contributions made in the year); 2) ComEd’s share of the pension benefit obligation (rather than the amount of expense to be recognized in the year); and 3) the overall funded status of ComEd’s share of the plan (rather than the prepayment of pension costs for the year). Because ComEd has not obligated itself to make pension plan contributions above the minimum required by law, which is supported by even more additional evidence in this matter on rehearing, it is clear to the Commission that the incentive the Commission allowed the Company back in Docket No. 05-0597 is no longer appropriate. Accordingly, the Commission adopts Staff’s definition of pension asset and accepts Staff’s

proposed adjustment. Once ComEd has an over funded pension plan, i.e., a pension asset as the Commission defines the term above and in its May 29 Order, then pursuant to Section 16-108.5(c)(4)(D) ComEd will be able to seek recovery through rates a return on that pension asset as set forth in the Act.

Proposed Modification
(PO On Rehearing, p. 30)

Finding and Ordering Paragraphs

* * *

(6) Commonwealth Edison Company shall be authorized to place into effect tariff sheets and associated informational sheets designed to produce annual tariffed revenues of ~~\$1,915,440,000~~~~1,950,664,000~~, which represent a decrease of ~~\$168,630,000~~~~133,406,000~~ or ~~7.626-03%~~;

ii. Staff's Position

The PO On Rehearing contains numerous mischaracterizations and misunderstanding of Staff's Position. One example is the last sentence in the second full paragraph under the section "Staff's Position" where the PO on Rehearing states "according to Staff ComEd cannot be deemed to have any pension asset before 2012." That statement is simply not true. Nowhere in Staff's case did Staff claim that "ComEd cannot be deemed to have any "pension asset" before 2012." Staff does not find any such discussion at the cite provided in the PO On Rehearing.

Another example of the mischaracterizations and misunderstanding of Staff's position in the Staff Position section of the PO On Rehearing can be found in the last sentence in the first full paragraph on page 20 wherein the PO On Rehearing states:

Staff argues that, because ComEd is already allowed recovery of its normal pension contributions as part of the pension expense, if ComEd were to be permitted to record a pension asset on its FERC Form 1, this would result in a double-counting of its mandatory pension contribution, first, through recovery as an operating expense and then again, through a return as a "pension asset."

The fact that ComEd **records** a pension asset on its FERC Form 1 does not impact the recovery of pension contributions. Staff has not taken issue with the accounting entries the Company has made for transactions for funding the pension plan. Rather it is the *ratemaking treatment* of the amount recorded as a pension asset that could result in double-counting. As Staff stated in its Initial Brief on Rehearing, if the pension asset as recorded on the FERC Form 1 is used for ratemaking purposes, then double counting of the normal, mandatory pension contributions could occur. (Staff IB on Rehearing at 10-11)

Yet another example of the mischaracterizations and misunderstanding of Staff's position in the Staff Position section of the PO On Rehearing can be found in the second full paragraph on page 20 of the PO On Rehearing which states that the Commission is permitted to set protocols pursuant to 220 ILSC 5/16-108.5(c)(4)(B). The PO On Rehearing does not mention that Staff noted that the protocols under 220 ILSC 5/16-108.5(c)(4)(B) and 220 ILCS 5/16-108.5(c)(4)(D) were **separate and distinct** from Staff's ratemaking proposal on rehearing. (Staff Initial Brief on Rehearing, p. 16) Staff was very clear that the protocols the Commission is permitted to set "subject to a determination of prudence and reasonableness consistent with Commission practice and law" for the recovery of pension and other post-employment benefits expense (220 ILCS 5/16-108.5(c)(4)(B)) and for the provision of an investment return on pension assets (220 ILCS 5/16-108.5(c)(4)(D)) are separate and distinct from Staff's ratemaking proposal. Staff explained that its ratemaking proposal concerns itself only with

ComEd's discretionary pension contributions which the Commission has in the past deemed to provide some benefit to ratepayers. (Staff Initial Brief on Rehearing, p. 16)

Due to these and other mischaracterizations and misunderstanding of Staff's position, the entire Staff's Position section of the PO On Rehearing should be deleted and replaced with the language below.

Proposed Modification
(PO On Rehearing, pp. 19-20)

[Delete the entire Staff's Position from the PO and replace with the following.]

Staff's Position

Staff recommends that the Commission uphold its May 29 Order which found that ComEd does not have a Pension Asset for purposes of the Formula Rate protocol under 16-108.5(c)(4)(B). Further, Staff argues that the Commission should follow its prior determinations regarding the definition of a pension asset. A discussion of that history (Staff IBR at 4-7) as well as a concise summary of the Commission's practice was provided on Table 1. (Id. at 8-10)

Staff summarized the Commission's prior practice with respect to ComEd's pension asset recovery requests as follows:

- 1) The Commission has never approved recovery of a pension asset for ComEd;
- 2) The Commission has twice defined a pension asset as one that exists when a pension trust fund is overfunded (i.e., the value of the investments in the pension trust fund exceed the pension obligations). (Docket Nos. 05-0597 and 11-0721);
- 3) The Commission has, on three occasions, granted a debt-based return on **only** the discretionary pension contribution to ComEd as an operating expense, in recognition that such prepayments mitigated future pension expense and resulted in a ratepayer benefit (Docket Nos. 05-0597, 07-0566, and 10-0467); and
- 4) The amount on which a debt-based return was allowed to recognize ratepayer benefits was significantly less than what the Company labeled a 'pension asset' in its FERC Form 1 report. (See Staff IB on Rehearing, Table 1)

Therefore, consistent with the Commission's practice, Staff recommended that the Commission should uphold its May 29 Order. (Staff IBR p. 10)

Staff's position is that the Commission's May 29 Order in this proceeding is consistent with its practice in that it did not recognize the existence of a pension asset given that the value of ComEd's pension fund investments did not exceed the value of its pension obligations. Moreover, consistent with the Commission's practice, Staff also noted that the Commission's May 29 Order did not accept the amount labeled by the Company as a "pension asset" in its FERC Form 1 as a pension asset for ratemaking purposes.

According to Staff, although the Commission has never recognized that ComEd had a pension asset, (Staff noted that the Commission used the term "pension asset" to refer to Exelon's 2005 \$803 million discretionary pension contribution in its Order on Rehearing in 05-0597. The Commission later corrected this on November 3, 2008 per its Amendatory Order in Docket No. 07-0566.) the Commission has also recognized, on three occasions, that discretionary pension contributions benefitted ratepayers and, thus, allowed a debt return based solely upon the discretionary pension contribution. While the Commission is not required to continue such ratemaking treatment in this proceeding, particularly given that the Company did not request the ratemaking treatment of the discretionary contributions that the Commission had provided in the past, the Commission may wish to consider this past practice in light of certain claims made by the Company in its application for rehearing, without disturbing the Commission's prior decision that there is no pension asset.

In order to address the Company's concern that ratepayers continue to benefit from the discretionary pension contributions and consistent with the Commission's past practice, Staff's ratemaking proposal provides for:

1. Debt return on the 2005 discretionary pension contribution - Per the Commission's Orders in Docket No. 05-0597 on Rehearing and in Docket No. 10-0467, this return amount would be calculated based on a hypothetical debt issuance by ComEd as if Exelon had not funded this discretionary pension contribution. The balance of this hypothetical debt would decline over time, so the calculated return can likewise be expected to decline. Since rates being developed in this docket are based on the 2010 calendar year, the appropriate corresponding return for the 2005 discretionary pension contribution is based on the assumed remaining balance of the hypothetical debt at the end of 2010 or \$19.346 million.
2. Debt return on the 2009 discretionary pension contribution limited to ratepayer benefit - Per the Commission's order in Docket No. 10-0467, this return amount was calculated by ComEd witness Kathryn M. Houtsma based on the ratepayer benefit in 2010 from the discretionary pension contribution made in 2009. (ComEd Ex. 29.6, p. 1 of 2, Nov. 23, 2010.) Since the rates being developed in this docket are based on the 2010 calendar year, the appropriate corresponding return for the 2009 discretionary pension contribution is \$6.464 million.

3. Debt return on the 2010 discretionary pension contribution limited to ratepayer benefit - In 2010, the discretionary pension contribution came from ComEd's internally generated funds – provided by ratepayers, not investors – and, thus, the return calculation based on a hypothetical debt issuance would not be appropriate to use here. Based upon the Company response to Staff Data Request TEE 13.02, the discretionary pension contribution made by ComEd in 2010 did not reduce 2010 pension expense. Therefore, there was no ratepayer benefit in 2010 that resulted from the 2010 discretionary pension contribution. The Company has indicated the ratepayer benefit from this 2010 discretionary contribution will not be realized until 2011. Staff noted that the protocols the Commission is permitted to set “subject to a determination of prudence and reasonableness consistent with Commission practice and law” for the recovery of pension and other post-employment benefits expense (220 ILCS 5/16-108.5(c)(4)(B)) and for the provision of an investment return on pension assets (220 ILCS 5/16-108.5(c)(4)(D)) are separate and distinct from this ratemaking proposal. As noted in Staff's IB on Rehearing, this proposal concerns itself only with ComEd's discretionary pension contributions which the Commission has in the past deemed to provide some benefit to ratepayers. (Staff Initial Brief on Rehearing pp. 13-14)

In Staff's opinion, if the Commission sees fit to continue its practice of granting a debt return on discretionary pension contributions (to the extent that ratepayers benefit from such contributions) then the Commission should adopt Staff's ratemaking proposal, and continue to find that no pension asset exists. As discussed in detail in the IB on Rehearing:

1. The evidence shows that no pension asset exists.
2. Discretionary pension contributions, to the extent they benefit ratepayers, may be beneficial to ratepayers.
3. A debt return on the portion of the discretionary contributions that benefit ratepayers is fair and reasonable.
4. Staff's proposal is consistent with past Commission practice.
5. Staff's proposal is responsive to the Company's complaint that the Commission's decision penalizes the Company for its contributions to its pension plan that are in excess of the minimum required by law.
6. Staff's proposal will provide a benefit to the Company in future formula rate cases, by offering a general policy that recognizes a long-term debt based return on discretionary pension contributions, when there is no pension asset recognized by the Commission, to the extent that the discretionary pension contributions benefit ratepayers in the applicable rate year. However, the proposal does not apply in future years wherein the Commission finds a pension asset exists. (Staff IB on Rehearing, p. 19)

Staff addressed each of the five arguments offered by ComEd in its Application for Rehearing, providing detailed explanations as to why they were unfounded and

flawed. ComEd offered response to only 2 of those in its Reply Brief on Rehearing. While Staff explained that the definition of the pension asset must consider both the value of the investment in the pension plan as well as the liabilities for which those investments are intended to cover (Staff IB on Rehearing, pp. 20-21), the Company claims that liabilities are only considered in the measurement of "equity" which is totally distinct from an "asset". (ComEd Reply Brief on Rehearing, p. 12) The Company missed the point of Staff's explanation.

Staff pointed to the evidentiary record to illustrate that the incentives that were provided through the return on the discretionary pension contribution in Docket No. 05-0597 are not achieving the desired results. By granting a return on the discretionary contributions, the Commission was providing incentive to ComEd to fully fund its pension plan. No commitment to fully fund the pension plans are to be found in either ComEd's or Exelon's 2010 financial statement. In fact, the evidence shows ComEd management is more concerned with minimum not maximum. (Staff IB on Rehearing pp. 25-26) ComEd in its Reply Brief on Rehearing claims that the incentive issue is "wholly irrelevant" (ComEd RB on Rehearing, p. 12) rather than addressing the facts set forth by Staff.

In its rebuttal testimony on Rehearing, ComEd claimed that any difference between the mandatory contribution and the discretionary contribution is "illusory" and has no impact on the recoverability of those contributions. Staff strongly disagreed since that distinction has been at the very heart of the Commission's decisions regarding the recovery of pension funding costs. Even ComEd's own witness Ms. Houtsma during cross examination agreed that the two types of contributions are different. (Tr., March 13, 2012, p. 910) The ComEd Board of Directors has always made the mandatory contributions but the decision to make discretionary contributions is carefully weighed based on a number of different factors. (Staff IB on Rehearing, p. 28)

Finally, Staff urged the Commission to maintain its position from the case in chief that since the pension plan was under-funded, no pension asset exists. However, if the Commission is persuaded that some allowance for the Company's discretionary contributions should be included in rates, an alternative ratemaking proposal, consistent with Commission practice is available according to Staff.

b. Staff's Ratemaking Proposal

It is Staff's position that the Commission should affirm its May 29 Order that ComEd has no pension asset since the value of its pension obligations exceed the value of its investments in its pension trust fund (Staff Ex. 24.0, pp. 9-15 and Staff IBR, pp. 4-5, 10) and that the definition of a pension asset is consistent with the definition adopted by the Commission in the past (Staff IB On Rehearing, p. 3). If the

Commission, however, wishes to consider its past practice of allowing a debt return on discretionary pension contributions in light of certain claims made by the Company in its application for rehearing, Staff has made a ratemaking proposal, which the Commission could adopt without disturbing the Commission's prior decision that ComEd has no pension asset. (Staff IBR, pp. 12-13) The arguments in support of the Staff ratemaking proposal are set forth in Staff's Initial Brief on Rehearing and Reply Brief on Rehearing and will not be repeated here.

Based on the foregoing discussion, the Commission could revise the Analysis and Conclusion on the pension asset issue as indicated below.

Proposed Modification
(PO On Rehearing, p. 21)

[Insert following Staff's Proposed Language to the Commission Analysis and Conclusion discussed above.]

While ComEd clearly does not have a pension asset for the reasons discussed above and in the Commission's May 29 Order, the Commission recognizes that discretionary pension contributions may provide a benefit to ratepayers by reducing pension expense. Therefore, the Commission finds it reasonable to adopt Staff's alternative ratemaking proposal set forth in the testimony of Staff witness Ebrey (Staff Ex. 24.0). Accordingly, consistent with the Commission's prior practice regarding ComEd's discretionary pension contributions in ComEd's recent general rate case orders and Section 16-108.5(c)(1), the Company is permitted under its formula rate to recover: (1) a long-term debt return on the 2005 discretionary pension contribution consistent with our May 24, 2011 Order in Docket No. 10-0467; and (2) a long-term debt return on the 2009 discretionary pension contribution limited to ratepayer benefit consistent with our May 24, 2011 Order in Docket No. 10-0467. The Commission also permits a long-term debt return for its 2010 discretionary pension contributions limited to ratepayer benefits; however, based upon the Company response to Staff Data Request TEE 13.02, the discretionary pension contribution made by ComEd in 2010 did not reduce 2010 pension expense. Therefore, there was no ratepayer benefit in 2010 that resulted from the 2010 discretionary pension contribution. The Company has indicated the ratepayer benefit from this 2010 discretionary contribution will not be realized until 2011. (Staff Ex. 24.0, Schedule 24.1, line 15; Staff Ex. 24.0, pp.10-11) Further, we are adopting Staff's ratemaking proposal that will provide a benefit to the Company in future formula rate cases, by offering a general policy that recognizes a long-term debt based return on future discretionary pension contributions, when there is no pension asset

recognized by the Commission, to the extent that the discretionary pension contributions are shown to benefit ratepayers in the applicable rate year. However, the ratemaking treatment would not apply in any years wherein the Commission finds a pension asset exists in accordance with the definition of pension asset adopted in this proceeding.

2. The Methodology Regarding Calculation of Interest on the Reconciliation Balance

The PO On Rehearing's analysis and conclusion on the interest rate issue is not grounded in the record evidence presented during this rehearing phase. The PO On Rehearing ignores the expert testimony of Staff witness Alan Pregozen, Manager of the Finance Department, and his 25+ years of experience in utility financial analysis. Rather than adopt Mr. Pregozen's recommendation, the PO On Rehearing erroneously sets the interest rate on the reconciliation balance equal to ComEd's so-called weighted average cost of capital ("WACC").² Specifically, the PO On Rehearing suffers four major flaws as it pertains to Staff's position.

First, the basis for the PO On Rehearing's conclusion, that capital is fungible and cannot be traced from source to risk, while correct, are not grounds to disqualify Staff's proposal. (PO On Rehearing, p. 23) Staff's proposal does not assume that the reconciliation under-recoveries will be financed with only a combination of short term debt and long term debt or just short-term debt. As a consequence, unlike other parties, Staff does not propose that the interest rate on the reconciliation balance be set equal to the short-term debt rate or even a combination of short and long-term debt rates. To

² The PO On Rehearing incorrectly conflates weighted average cost of capital ("WACC"), an economic concept that describes a cost determined in the financial market, with rate of return on rate base, a legal concept that describes a rate set by the Commission (with the rate of return on common equity prescribed by formula in 220 ILCS 5/16-108.5(c)) Despite this confusion, Staff will also use the term "WACC" as shorthand for rate of return on rate base.

the contrary, Staff proposes the interest rate be calculated using the same capital structure and embedded costs of debt as ComEd's overall "WACC."

Staff's proposed interest rate departs from ComEd's position, which the PO On Rehearing adopts, in one respect only: it correctly adjusts the rate of return on common equity to reflect the two year delay between the rate year (the rates for which are based on a preliminary revenue requirement) and the year in which the reconciliation balance is included in rates.³ This approach is consistent with the Commission's Order in Docket No. 10-0138, which adopted a rate of return on common equity that reflected the shorter recovery period for assets under the purchase of receivables and consolidated billing (PORCB) rider. (Docket No. 10-0138 Order at 39 and 51.)

Second, in adopting ComEd's overall "WACC" for the reconciliation balance, the PO On Rehearing states: "The record supports a finding that reconciliation under-recoveries will likely be typical utility investments and expenses." (PO On Rehearing, p. 29) This statement seems to confuse the return authorized on rate base investments, which is already a component of the reconciliation balance, with the interest on the reconciliation balance, the purpose of which is to compensate for the delay in recovering the authorized return on rate base (and delay in recovering operating expenses). Moreover, this statement implies that the type of expenditure included in the reconciliation balance is relevant to the interest rate. This is true to the extent that the expenditures included in the reconciliation balance are subject to the same sales risk

³ Unlike debt, common equity does not have an embedded cost. Consequently, if ComEd's asset holdings change, then the cost of ComEd's common equity changes. In contrast to debt, which has interest rates set at the time that debt is issued and remain in effect until that debt is retired, ComEd is not stuck with an obligation to pay higher rates of return on "legacy" common equity regardless of changes in the weighted average riskiness of the assets ComEd owns. (Staff RB On Rehearing, pp. 35-36)

and prudence and reasonable cost determinations as other components of the revenue requirement. Nonetheless, it ignores the critical dimension of investment time horizon, which most parties, including ComEd, agree is two years. This is quite unlike rate base, which has an average life in excess of 30 years. (Staff Ex. 25.0, p. 3, fn 2) Staff notes that the record shows, without contradiction, that both the time value of money (as manifested in yields of U.S. Treasury securities) and the risk premium (as manifested in the spreads of corporate bond yields in comparison to U.S. Treasury securities with the same terms to maturity) vary with investment time horizon. (Staff Ex. 25.0, pp. 3-4) To apply a rate of return that reflects the time value of money and investment risks for a thirty-year investment to a two-year investment is patently unjust and unreasonable.

Third, while the PO On Rehearing correctly describes part of Staff's investment time horizon adjustment (i.e, the replacement of the 30-year U.S. Treasury bond yield with the 2-year U.S. Treasury note yield), it inexplicably omits the description of Staff's proposed time horizon adjustment to the 580 basis point common equity risk premium. Both components of the investment time horizon adjustment are consistent with important Commission precedent from Docket No. 10-0138. (Order, Docket No. 10-0138 Order, December 15, 2012, pp. 39 and 47-51)

Fourth, Staff was concerned that its position on the income tax issue would be conflated with those of CUB and AG/AARP. (Staff IB On Rehearing, p. 52) Despite that explicit warning, the Proposed Order does exactly that and states that the issue is outside the scope of the application for rehearing. (PO On Rehearing, p. 29) The income tax issue is not outside the scope of rehearing, as Staff's IB On Rehearing

describes at pages 48 through 53. The income tax rate is a vital component of the interest rate and could not be outside the scope of rehearing.

Staff's position on the income tax adjustment is not based on when ComEd records a deferred income tax liability. Rather, Staff's position is that the determining factor is when the income taxes are paid. Specifically, ComEd does not pay the income taxes included in the reconciliation balance in advance of recovering those income taxes from rate payers. Rather, ComEd pays those income taxes concurrently with recovering them from ratepayers. (Staff IB On Rehearing, pp. 52-53) Consequently, the PO On Rehearing's conclusion would result in ComEd earning interest on amounts it has yet to expend. That, too, is patently unjust and unreasonable.

Based on the foregoing discussion, Staff offers the following modifications to the PO On Rehearing:

Proposed Modification
(PO On Rehearing, pp. 23-24)

Staff's Position

Staff explains that in the initial phase of the proceeding, it viewed the formula rate reconciliation adjustment as similar to other riders with a true-up mechanism designed to recover the exact costs incurred. As a result, Staff recommended the same interest rate for the formula rate reconciliation adjustment as was applied to certain other riders' balances: the customer deposit rate, determined by the Commission annually. In this rehearing phase, Staff has concluded that the formula rate reconciliation adjustment is also subject to the same determination of prudence and reasonableness as well as the same degree of sales risk as the revenue requirement. Based upon this understanding, Staff's analysis on the interest rate component in this rehearing phase explicitly recognizes the two-year delay in recovering the reconciliation balance and that recovery of the reconciliation balance is exposed to the same prudence, reasonableness and sales risks as the other components of a utility's revenue requirement. (Staff Initial Brief on Rehearing at 39-40).

Staff argues that the Company's authorized rate of return on rate base reflects the investor-required rate of return on equity into perpetuity. In contrast,

reconciliation adjustments have a life of two-years. Staff maintains that all else being equal assets with different lives have different required rates of return and therefore the common equity component of the interest rate should take the investment time horizon into account. For example, on July 20, 2012, 2- and 30-year U.S. Treasury bond yields were 0.22% and 2.55%, respectively. This differential is a consequence of differences between two-year and thirty-year expectations regarding interest rate risk and the nominal risk-free rate, the latter of which includes inflation expectations. (Staff Initial Brief on Rehearing at 41).

Staff explains that risk premium is also a function of the time horizon of the investment. For example, the average 2011 spread of investment grade corporate debt yields over U.S. Treasury bond yields of the same term to maturity was 61 basis points higher for 15+ year investment grade corporate bonds than for 1-3 year investment grade corporate bonds. Therefore, the common equity component of the interest rate should take the investment time horizon into account. (Staff Initial Brief on Rehearing at 41).

Staff explains that section 16-108.5(c)(3) of the Act determines the rate of return on common equity that is incorporated into the overall rate of return on rate base in two parts. The first part is the average 30-year U.S. Treasury yield. The second component is a risk premium of 580 basis points. Staff states that because the investment time horizon for the reconciliation adjustment balance is two years, the Commission should replace the 30-year U.S. Treasury yield with the two-year U.S. Treasury yield in calculating the interest rate for the reconciliation balance and multiply the 580 basis point common equity risk premium by the ratio of a shorter term corporate bond spread to a longer term corporate bond spread. Given its availability to the public through the Federal Reserve Bank of St. Louis's FRED⁴ web site, Staff recommends that the Bank of America Merrill Lynch ("BAML") index of 1-3 year investment grade corporate bond yield spreads serving as the numerator of the ratio while the BAML index of investment grade corporate bonds with remaining terms to maturity of 15 years or greater serving as the denominator of the ratio. This investment time horizon adjustment to the equity premium is shown on lines (1) through (5) of Schedule 25.1. of Staff Ex. 25.0. When using the BAML indices for the investment time horizon adjustment, the common equity component to the interest rate on the reconciliation adjustment would be calculated as follows:

$$\begin{array}{c} \text{2-Year U.S.} \\ \text{Treasury Yield} \end{array} \quad \pm \quad \frac{\begin{array}{c} \text{1-3 year BAML bond} \\ \text{yield spread} \end{array}}{\begin{array}{c} \text{15+ year BAML bond} \\ \text{yield spread} \end{array}} \quad \times \quad \underline{5.80\%}$$

⁴ FRED is an acronym for "Federal Reserve Economic Data."

(Staff Initial Brief on Rehearing at 42-43)

Staff does not recommend a risk adjustment to the common equity component of the interest rate because the reconciliation balance is subject to the same prudence (i.e., regulatory) and sales risks as rate base assets. (Staff Initial Brief on Rehearing at 44-43).

Staff adds that unlike the cost of common equity, it does not recommend an investment time horizon adjustment to the Company's cost of debt. Staff finds that estimating the Company's marginal cost of debt for a two-year term to maturity and applying that to the reconciliation adjustment would be theoretically superior to using the embedded cost of long-term debt, but would necessitate removing from the Company's ratemaking capital structure the debt reflected in the interest rate on reconciliation adjustments to avoid counting that debt twice. Staff states that not only could that be a difficult endeavor, but an unnecessary one, since such an adjustment should result in the same debt cost recovery as using the same cost of debt for both the overall rate of return on rate base and the interest rate on the reconciliation adjustment. (Staff Initial Brief on Rehearing at 44).

Staff did not submit testimony on whether interest should be earned on the income tax portion of the reconciliation balance but has formed a position on this issue from the evidence submitted by other parties. Staff agrees with Mr. Brosch, Mr. Efron, and Mr. Smith that the interest rate should be calculated on a net of tax basis. Staff explains that interest compensates for the time that elapses between when an expenditure is made and when that expenditure is reimbursed. Since there is no lag between when the income taxes included in the reconciliation balance are payable and when they are recovered through rates, the income tax portion of the reconciliation balance should not earn interest. Further, Staff also finds that the formula for effectively excluding the income tax balance from the calculation of interest on the reconciliation balance is $\text{Annual Interest Rate} \times (1 - \text{Composite Income Tax Rate}) = \text{Annual Interest Rate Net of Income Taxes}$. (Staff Initial Brief on Rehearing at 48, 52-53). ~~Staff has concluded that interest should not be earned on the income tax portion of the reconciliation balance.~~

Proposed Modification
(PO On Rehearing, pp. 28-29)

Analysis and Conclusion

Each party on rehearing had different recommendations. ComEd advocated use of its WACC for both under and over-recovered reconciliation balances and maintains that the WACC is the only proposed interest rate that complies with the statute. The Company also suggests that the AG, CUB, and

Staff reach beyond the scope of this rehearing in asking the Commission to adjust the reconciliation amount to reflect certain tax calculations.

Staff proposes the interest rate be calculated using the same capital structure and embedded costs of debt as ComEd's overall WACC but adjusts the rate of return on common equity component to reflect the investment time horizon of the two-year delay between the rate year and the year in which the reconciliation balance is included in rates. For the rate of return on common equity component of the interest rate, Staff recommends replacing the 30-year U.S. Treasury yield with the two-year U.S. Treasury yield and multiplying the 580 basis point common equity risk premium by the ratio of yield spreads on the BAML index of 1-3 year investment grade corporate bonds to the BAML index of investment grade corporate bonds with remaining terms to maturity of 15 years or greater.

~~Staff and the Intervenor generally agree that the WACC should not be applied to under and over-recoveries and also agree that no interest should be applied to the portion of the reconciliation balance that represents deferred taxes. Staff recommends a formula to determine the applicable interest rate that is based on applying a two-year U.S. treasury yield and a Bank of America Merrill Lynch ("BAML") index of 1-3 year investment grade bonds and a 580 basis point equity premium to determine the time adjusted cost rate. AG/AARP recommend that the Commission approve a blended reconciliation rate that relies upon current interest rates for newly issued debt that recognize the two-year delay in reconciling actual costs. Mr. Brosch proposed a blend of short- and long-term debt based on current market rates for corporate bonds and short-term non-financial commercial paper to produce an interest rate based upon current marginal costs of short/long term debt of 2.53%. CUB-City recommend that the Commission adopt the AG's recommended 2.53% for under-collected reconciliation balances, but maintain that the WACC is the appropriate interest rate to apply to over-recoveries. IIEC maintains that the WACC is inappropriate and that ComEd's short-term debt costs are a more accurate estimate of the carrying charge for the reconciliation balance. The Commercial Group argues that the reconciliation interest rate should not be set at the WACC but at either the hybrid rate the Commission adopted in the May 29 order or some other reasonable rate supported by the evidence in this proceeding.~~

Despite the disagreements, the general consensus amongst all of the parties is that the interest rate approved on reconciliation balance is intended to compensate for the time value of money. Some parties maintain that ComEd will finance under-recovery balances with short-term debt. This argument is based on the assumption that it is possible to trace capital from source to use. In the context of utility rate cases, this is an assumption that the Commission typically rejects because cash is fungible. One exception is the assumption that short-term debt is the first source of capital used to finance CWIP. This assumption, however, is a regulatory prescription not an economic one. It is simply a

regulatory determination made in calculating the interest rate accrued on AFUDC associated with CWIP.

From an economic perspective, the Commission continues to generally believe that cash is fungible and can not be traced from source to use. In the case of an under-recovery balance, it is not clear to the Commission that ComEd would rely exclusively on short-term debt, or debt, to fund the under-recovery. The Commission would not expect ComEd to totally change the way it manages its capital structure. The Commission does not believe the record on rehearing supports a finding that ComEd will or should finance reconciliation under-recoveries with only debt or short-term debt. The record supports a finding that reconciliation under-recoveries will likely be typical utility investments and expenses, some which may be capitalized, and will be financed with ComEd's capital just like other investments and expenses. We note that Staff's recommendation does not trace funds from source to use. It uses the same capital structure and embedded costs that would be used for the rate of return on rate base. The only difference is that Staff's recommendation correctly recognizes that cost of common equity is not an embedded cost and that it is a function of investment time horizon. This is consistent with our Order in Docket No. 10-0138:

After giving thorough consideration to the parties' arguments, the Commission finds that Staff's position is more reasonable and superior to that of ComEd. The overall risk of a company is a function of the risk of the individual assets of that company. Thus, a company's overall cost of capital relates to the riskiness of the individual assets that are owned by the company. This is in contrast to the situation in a traditional rate case, where it is not necessary to focus on the risk of individual assets included in rate base. (Order, Docket No. 10-0138, December 15, 2010, p. 47)

Moreover, the uncontroverted evidence that was presented by Staff established that the cost of capital is a function of the weighted-average riskiness of all of a company's assets, including those whose costs are recovered through base rates and those whose costs are recovered through true-up mechanisms. As the proportion of ComEd's costs that are recovered through rider mechanisms with true-ups increases, its cost of capital will decrease. (Order, Docket No. 10-0138, December, 15, 2010, p. 50)

The Commission finds that the ~~WACC is the~~ appropriate interest rate to apply to under-recovered reconciliation balances equals (1) the product of the rate of return on common equity calculated using the procedure shown in ICC Staff Exhibit 25.1 and the common equity ratio included in the authorized rate of return on rate base; plus (2) the weighted costs of the remaining (i.e., non-common

equity) components of the capital structure included in the authorized rate of return on rate base.

~~As for reconciliation over-recoveries, the Commission maintains that WACC is by definition ComEd's time value of money and that over-recoveries should not be treated any differently than under-recoveries.~~

~~Regarding whether interest should be applied to the portion of the reconciliation balance₁ that represents deferred taxes. Further, the Commission finds that this issue is outside of the scope of the application for rehearing since interest compensates for the time that elapses between when an expenditure is made and when that expenditure is reimbursed, it follows that interest should not be accrued on any portion of the reconciliation balance that is not paid out in advance of its inclusion in rates. The evidence shows that there is no lag between when the income taxes included in the reconciliation balance are payable and when they are recovered through rates. Permitting ComEd to accrue interest on amounts that it has yet to pay out would be unjust and unreasonable. Therefore, the Commission concludes that the interest rate formula described in the preceding paragraph shall be multiplied by the composite income tax rate to effectively eliminate the accrual of interest on income taxes.~~

As for reconciliation over-recoveries, the Commission maintains that over-recoveries should not be treated any differently than under-recoveries.

III. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission's order in this proceeding reflect all of Staff's recommendations regarding the Company's tariffs and charges submitted pursuant to Section 16-108.5 of the Act.

Respectfully submitted,

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